IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Nos. 96-2220, 96-2236

MARY A. BUCHANAN and GORDON BUCHANAN, JR.,
Plaintiffs-Appellees, Cross-Appellants,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant, Cross-Appellee.

Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 91 C 3831—**James B. Moran**, *Judge.*

SUBMITTED MAY 28, 1996—DECIDED JUNE 20, 1996

Before POSNER, *Chief Judge*, and ROVNER and EVANS, *Circuit Judges.*

POSNER, *Chief Judge.* The government appeals for the second time from the judgment in favor of the taxpayers in this tax refund suit. After we dismissed the government's initial appeal (along with the taxpayers' cross-appeal from the refusal of the district court to impose sanctions on the government for alleged discovery abuses) because the district judge had not entered a final, appealable judgment, specifying the amount of the refund due the taxpayers, *Buchanan v. United States*, No. 95-3057 (7th Cir. April 9, 1996) (per curiam), the judge repaired this deficiency and entered a new judgment, from which

the government prosecutes a new appeal and the taxpayers a new cross-appeal. We said in our previous opinion that we would decide the new appeals without further briefing or argument.

The taxpayers claim to be entitled to deduct, from the federal income taxes that they paid in 1986 and 1987, a nonbusiness bad debt of $2.1 million that they say became completely worthless in 1986. If the claim has merit, as the district judge ruled on cross-motions for summary judgment, the taxpayers are entitled to a refund of more than half a million dollars.

The Internal Revenue Code allows the deduction of a nonbusiness debt that "becomes worthless within the taxable year," 26 U.S.C. § 166(d)(1)(B). The criterion of worthlessness is interpreted strictly: the deduction is unavailable if ever a modest fraction of the debt can be recovered. Treas. Reg. § 1.166-5(a)(2) ("wholly worthless"); *Bodzy v. Commissioner*, 321 F.2d 331, 335 (5th Cir. 1963) ("last vestige of value" must have "disappeared"); *Clanton v. Commissioner*, 70 Tax Ct. Mem. Dec. (CCH) 534 (1995) ("partial worthlessness is insufficient"). The reason for this hard line is plain. Because people rarely make nonbusiness loans to strangers, or even to friends, the domain of the nonbusiness debt is limited largely to the family. (Not entirely: some nonbusiness bad debts result simply from uninsured deposits in financial institutions that go broke. See Rev. Rul. 71-577, 1971-2 Cum. Bull. 129.) Gifts and loans within the family are difficult to distinguish; so if nonbusiness loans could easily be written off to produce a tax savings, the potential for obtaining a tax deduction for gifts to members of one's family would be immense. See H.R. Rep. No. 2333, 77th Cong., 1st Sess., reprinted in 1942-2 Cum. Bull. 372, 408-09; 2 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 33.6, p. 33-21 (2d ed. 1990).

The taxpayers in this case are Mr. and Mrs. Buchanan. Their daughter was married to the owner of a retail jewelry business that over the years had borrowed heavily from

a bank. Mr. Buchanan had in effect guaranteed the loans by signing the promissory notes of the jewelry business as co-obligor and by backing his assumption of the obligation with a pledge of stock. He had even borrowed $300,000 from the bank himself to reloan to the business. In 1986 the bank learned that the jewelry business was on or over the brink of insolvency. It threatened to call Buchanan's guaranty and sell some of the stock that he had pledged as collateral. In response to this threat Buchanan gave the bank his personal note, payable on demand, for $2.1 million, which was the aggregate unpaid balance of the loans that he had guaranteed ($1.8 million) plus the loan ($.3 million) that he had obtained to relend to the jewelry business. The business later gave Buchanan its note, guaranteed by the son-in-law, for this amount.

The Buchanans argue that the $2.1 million debt of the jewelry business to Mr. Buchanan arose from a nonbusiness loan that was worthless on the day he gave the bank his personal note for that amount, June 30, 1986, because the business had by that date become insolvent. Yet in the following two years, 1987 and 1988, the Buchanans received $242,000 in interest and principal from the jewelry business in partial payment of the allegedly worthless debt. It seems they should not have received any of that money. Their daughter had died shortly before her father had executed his personal note to the bank. Her widower, the son-in-law, had become the trustee of his deceased wife's estate. He improperly siphoned assets of the estate into his failing business, where they were used to pay some of his creditors, including his former father-in-law. He improperly diverted payroll taxes to the same creditors. Without these improper infusions of capital into the failing jewelry business it is unlikely that the taxpayers would have received anything on their debt unless they had sued the jewelry business promptly in 1986 and obtained a judgment, putting them ahead of the business's other unsecured creditors.

Both the jewelry business and the son-in-law later declared bankruptcy. The taxpayers expect to obtain $45,000

from the estate in bankruptcy of the former and $20,000 from the estate in bankruptcy of the latter. Although the taxpayers have been forced to pay back, as a voidable preference, $68,000 of the $242,000 in interest and principal that they received from the jewelry business before it declared bankruptcy, it appears that they have already received $241,000 from the estates in bankruptcy of the jewelry business and the son-in-law. So it looks as if they will eventually recoup $480,000 ($45,000 + $20,000 + $242,000 − $68,000 + $241,000) of the $2.1 million debt. We use weasel words ("it appears," "it looks as if") because the $480,000 figure is not firm, but is merely our best surmise from a confusing record. No matter. As will soon become clear, the case must be decided the same way whether the amount recovered by the Buchanans is $480,000 or $240,000.

The $2.1 million debt of the jewelry business to Buchanan was worthless on June 30, 1986, within the meaning of the applicable provision of the Internal Revenue Code, if on that date he had (1) no reasonable prospect, *Kugel v. Ryan*, 289 F.2d 329 (2d Cir. 1961); *Oatman v. Commissioner*, 45 Tax Ct. Mem. Dec. (CCH) 214 (1982), of recovering (2) a significant, though in the sense merely of nontrivial, fraction of this amount. Rev. Rul. 71-577, *supra* (more than "one or two cents on the dollar"); cf. *Rodgers v. Commissioner*, 49 Tax Ct. Mem. Dec. (CCH) 1434 (1985). Recovery of a trivial fraction of the debt would be unlikely to cover the costs of collection, while a miraculous, unforeseen, unforeseeable, totally unexpected recovery of part or even the whole of a debt properly written off as worthless years before—the kind of recovery that might have occurred here if in 1990 the son-in-law had won first prize in the Illinois state lottery—would be consistent with the debt's having properly been deemed worthless in the year it was written off. See *Crown v. Commissioner*, 77 T.C. 582, 598 (1981); *Wolfson v. Commissioner*, 45 Tax Ct. Mem. Dec. (CCH) 244 (1982). A judgment of worthlessness has an inescapable predictive element, and no prediction can attain metaphysical certainty.

The proposition that the recovery of a tiny amount of a debt, even if fully anticipated rather than completely unpredictable, will not defeat a finding of worthlessness is in only superficial tension with the language quoted earlier from the treasury regulation ("wholly worthless") and the cases. That language is not intended to be taken literally. Its purpose is to emphasize that a nonbusiness debt is not deductible merely because it has lost most of its value.

Neither condition for the deduction of a nonbusiness bad debt—a merely trivial repayment, or a miraculous repayment—was satisfied here (a third condition, that the debt be bona fide, we are assuming is satisfied); and so clear is this that the government was entitled to summary judgment. This is so even though we may assume that the $480,000 (or whatever) that the jewelry business paid Mr. Buchanan in partial repayment of the money that he had been forced to pay the bank to honor his personal note to the bank was the payment of a debt, and not just a gift. If it was the latter, then the $2.1 million was not a debt. The argument that the $480,000 was merely a gift runs as follows. The personal note that Buchanan gave the bank was actually a form of payment to the bank, discharging the obligations of the jewelry business as well as Buchanan's prior obligations as guarantor and borrower. If so, then the jewelry business owed Buchanan nothing until it executed its own note, which came after the jewelry business was bankrupt, making the note worthless when issued. We do not consider this a realistic reconstruction of the parties' relationship. It is more realistic to regard Buchanan's $2.1 million note to the bank as a confirmation of a preexisting debt of the jewelry business to him, a debt that had value because the jewelry business was not insolvent when the debt was incurred.

We may further assume that the debt was the consequence of a series of bona fide loans to the jewelry business, that when these loans were made (including the last loan, made directly to Buchanan but with the understanding that he was going to turn around and relend the proceeds to the jewelry business) the business was solvent,

and that it became insolvent on or shortly before June 30, 1986. Of course a debt is not worthless merely because the debtor is insolvent. Secured creditors often recover the full amount of their debt from an insolvent debtor, and unsecured creditors often recover a significant fraction, at least, of what they are owed by such a debtor. So far as appears, had Mr. Buchanan, upon learning from the bank when it asked him to give it his personal note that it thought his son-in-law's business insolvent, acted promptly to obtain a judgment against the business, he would have recovered a substantial fraction of the $2.1 million that it owed him. He may have forborne because of the family relation. That is the very reason for interpreting "worthless" in the provision allowing the deduction of nonbusiness debts strictly, and for regarding the failure to pursue available realistic remedies as an indicator that the debt has some value (for that is implicit in saying the creditor *had* realistic remedies). Cf. *Cole v. Commissioner*, 871 F.2d 64, 67 (7th Cir. 1989). But the record is insufficiently developed to allow us to conclude, with the certitude required for summary judgment, that an immediate effort to collect the debt would have been the prudent course for a stranger in Mr. Buchanan's shoes to have followed.

Even so, we do not think the debt can be pronounced worthless, when we consider that, despite Buchanan's failure to sue (a failure that, as we just noted, casts doubt on the worthlessness of the debt), he has recovered or will recover such a substantial amount of the debt. A recovery of $480,000, or even of a much smaller amount, of a $2.1 million receivable is substantial in both absolute and relative terms. The debt to Buchanan has lost most of its value, but it is not worthless. The taxpayers wisely do not argue that so much of their nonbusiness debt as has not been repaid and is unlikely to be repaid, which is to say $2.1 million minus the $480,000 that, as best we can estimate, will be their total recovery, will be deductible in the tax year in which the hope of further recovery is finally extinguished. Such an approach,

in which the unpaid balance of a partially recovered debt is severed from the original unpaid balance and characterized as a separate, totally worthless debt, would defeat the requirement of showing complete (well, nearly complete, for the reason explained earlier) worthlessness.

Instead the taxpayers make two linked arguments. The first is that the entire repayment, the entire $480,000 that they have received or will receive in part payment of the $2.1 million debt from the jewelry store and the son-in-law, its owner, is due to the son-in-law's misconduct. This is a very curious argument in the taxpayers' mouths. It implies that they are not entitled to retain the $480,000—yet they are making no effort to repay it, or even acknowledging that it is not rightfully theirs. If they forthrightly acknowledged that the equitable right to the money lies elsewhere, so that they haven't actually received any part of the $480,000 except as constructive trustees for the equitable owners, then the debt may indeed be worthless; they will have lost the entire $2.1 million. Instead they seem to be arguing that although they should not have gotten the $480,000, it is theirs to keep—yet *because* they are not really entitled to it they should get a tax refund too. This is *very* strange logic, even for a tax case, especially since some of the $480,000 was siphoned from payroll taxes. They want to keep the proceeds of what they themselves describe as a tax fraud *and* get a tax deduction besides.

Yet undeserved as their partial recovery of the debt is and paradoxical as is their argument for the deduction, shouldn't the partial recovery of the debt be classified with lottery winnings as a totally unexpected mode of recovering a debt, a pure windfall, manna from heaven—and hence consistent with the theory that the debt really became worthless in 1986? We think not, considering the familial setting. The son-in-law funneled money from his wife's estate and the Internal Revenue Service to the wife's parents. This could not be thought a totally unforeseeable consequence of his inability to repay the parents, his former in-laws, directly. He would at least

be keeping the money within the family, and he might therefore hope to see some of it himself. This funneling accounts for the bulk of the $480,000. The source for the rest is the assets of the son-in-law and his business, and is further evidence that the Buchanans' debt, though an unsecured debt of an insolvent enterprise, was not completely uncollectable.

The Buchanans' second argument is that the Internal Revenue Service has imparted value to a valueless debt by unaccountably, or perhaps strategically, failing to go after the son-in-law for what the Buchanans describe as his embezzlement of the assets of their daughter's estate, as well as his conversion of payroll-tax trust funds. The Service has not treated the assets that the son-in-law withdrew from the estate without authorization and funneled to the Buchanans as income to him, as it presumably could have done. Nor has it attempted to impose upon him the punitive sanctions that the law authorizes for the conversion of payroll tax receipts. Yet the Buchanans' argument is again a curious one, and for the same reason. Had the Service proceeded as the Buchanans say it should have done they would not have received any of the $480,000 unless they are the beneficiaries of the trusts created by their daughter's will, of which there is no suggestion. They would, it is true, have received something even better—a tax refund worth more than $500,000. But the Internal Revenue Service is not required to conduct its affairs in a way designed to minimize the taxes that a particular taxpayer owes. Cf. *Stevens v. United States*, 49 F.3d 331 (7th Cir. 1995); *United States v. Security Pacific Credit, Inc.*, 956 F.2d 703, 706 (7th Cir. 1992); *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186, 1191 (7th Cir. 1989). For all we know, the son-in-law never had enough income or assets to pay the taxes and penalties to which he might have been exposed had the Service gone after him. Even if he did, the Service was under no obligation to pursue him merely for the sake of enabling the Buchanans to obtain a bad-debt deduction. You can't resist the payment of taxes on the ground that someone else isn't being made

to pay his fair share. *United States v. Michaud*, 860 F.2d 495, 499 (1st Cir. 1988).

To summarize, the source—whether tainted, as in this case, by a breach of trust or other unlawful conduct, or not—of payment or part payment of a nonbusiness debt is irrelevant to whether the debt has value, unless the source, as in our example of the lottery, and therefore the payment, are unforeseeable. That condition is not satisfied, and so the judgment for the taxpayers must be reversed with directions to enter judgment for the government and dismiss the suit. The cross-appeal challenges the district court's refusal to impose sanctions on the government for alleged concealment of evidence. The challenge has no merit, for a variety of reasons unnecessary to discuss.

REVERSED.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

July 30, 1996

Before

Hon. RICHARD A. POSNER, Chief Judge

MARY A. BUCHANAN, individually and
as personal representative of the
Estate of GORDON BUCHANAN, Jr.,

Plaintiff-Appellee,

Nos. 96-2220 and 96-2236 v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 91 C 3831—James B. Moran, Judge.

Upon consideration of the MOTION TO CLARIFY THE RECORD, filed on July 3, 1996, by counsel for the appellees,

IT IS ORDERED that the motion is DENIED.

[Dated June 27, 1995]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

MARY BUCHANAN and GORDON BUCHANAN, JR.,	)	
Plaintiffs,	)	
vs.	)	No. 91 C 3831
UNITED STATES OF AMERICA,	)	
Defendant.	)	

MEMORANDUM AND ORDER

Plaintiffs Gordon and Mary Buchanan brought this federal tax refund action alleging an overpayment of their joint tax return for 1986 and/or 1987 in the amount of $542,451. Plaintiffs claim that they are entitled to a deduction for those tax years under 26 U.S.C. §166(d) for a nonbusiness bad debt. Plaintiffs and the defendant, the United States of America, have filed cross-motions for summary judgment. For the reasons set forth below, plaintiffs' motion is granted and the government's motion is denied.

BACKGROUND

Plaintiffs' son-in-law, Stewart S. Peacock (Peacock) was the president and sole shareholder of a retail jewelry business called Spaulding & Company (Spaulding). For several years prior to 1986, Spaulding had taken out

loans with the First National Bank of Chicago (First Chicago), which by mid-1986 totaled $1.8 million. Prior to June 1986, Spaulding and Gordon Buchanan (Gordon) were co-obligors of this debt. As collateral for Spaulding's loan, First Chicago held Gordon's 52,590 shares of Standard Oil of Ohio (Sohio).

In May 1986, First Chicago became aware that Spaulding was experiencing financial difficulties. At that time Spaulding provided First Chicago with financial statements indicating that it was essentially insolvent. Concerned with this turn of events, First Chicago threatened to call the debt and sell Gordon's Sohio shares to pay off the loan unless Gordon agreed to become the sole obligor of the Spaulding indebtedness. Around that same time First Chicago rejected, for the first time, a loan request of Spaulding. Meanwhile, Sohio was the subject of rampant takeover rumors circulating the financial world. It seemed that British Petroleum might make a tender offer for the outstanding Sohio shares at a greatly inflated rate. Thus, by June 1986, Gordon either had to become the sole obligor of Spaulding's indebtedness or lose out on a substantial amount of money if and when British Petroleum made a tender offer.

Not surprisingly, Gordon elected to become sole obligor of Spaulding's debt in June 1986. At that same time, Gordon tendered an additional 17,000 Sohio shares to secure a $300,000 loan from First Chicago, which funds he promptly turned over to Spaulding. On 30, 1986, Gordon executed a promissory note of $2.1 million to First Chicago, a loan secured by the Sohio stock already in First Chicago's possession. Through this restructuring Spaulding was no longer obligated to First Chicago.

Gordon was anxious to retain possession of his Sohio shares so that he could capitalize on the expected tender offer from British Petroleum. As a result, he borrowed $2.1 million from a brokerage house in April 1987, and paid off Spaulding's debt. First Chicago then released Gordon's Sohio shares. One month later Gordon sold his Sohio stock to British Petroleum in a public tender offer, which generated a capital gain in the amount of $4,834,465. Gordon repaid the brokerage house $2.1 million, as well as $14,000 in interest one month later.

In June 1987, Spaulding first executed an installment note to Gordon in the amount of $2.1 million, plus interest, payable over a five-year period. Peacock guaranteed the installment note, pledging all his shares of Spaulding stock as collateral. Spaulding and Peacock also executed a security agreement giving Gordon a security interest in Spaulding's inventory, accounts receivable, and stock.

Spaulding paid the required monthly payments to Gordon throughout the remainder of 1987 and up to August 1988. On November 21, 1988, Gordon filed an involuntary bankruptcy petition against Peacock and Spaulding. Subsequently, Gordon agreed to dismiss the petition after Spaulding turned over its inventory to him. On April 17, 1989, Spaulding filed a petition for voluntary bankruptcy. In this proceeding the bankruptcy court stripped Gordon of his secured status and ordered him to return Spaulding's payments made between May and August of 1988, finding that these actions were avoidable as preferences because Spaulding was insolvent at least by July 31, 1986. Gordon has since, in 1993 and 1994, recovered payments from both Peacock's and Spaulding's bankruptcy estates in the amount of $240,628, mostly

from Peacock's bankruptcy estate, and may potentially recover about $65,000 more in the future.

On December 23, 1988, and January 5, 1989, plaintiffs filed amended returns for the 1986 and 1987 tax years respectively, claiming additional deductions for nonbusiness bad debt. The Internal Revenue Service (IRS) denied plaintiffs' claims for both years.

On June 21, 1991, plaintiffs filed this action for a federal tax refund for their joint tax returns for 1986 and 1987, claiming a deduction for a nonbusiness bad debt related to the Spaulding indebtedness. The government argues that plaintiffs are not entitled to the deduction under §166 because they cannot prove the existence of a bona fide debt and, alternatively, because they cannot prove that that debt was completely worthless in either 1986 or 1987. Plaintiffs claim that the June 1986 restructuring of the Spaulding indebtedness created a debt from Spaulding to Gordon for $2.1 million and that this debt became worthless in either 1986 or 1987. The parties have filed cross-motions for summary judgment.

DISCUSSION

A. *Section 166(d)*

For plaintiffs to be successful in this refund action they must identify a specific section of the Internal Revenue Code granting them a deduction. *Harco Holdings Co. v. United States*, 977 F.2d 1027, 1037 (7th Cir. 1992) (holding that deductions are a matter of legislative grace). Plaintiffs claim that Gordon's financial dealings with Spaulding qualify as a nonbusiness bad debt under §166(d). Section 166(d) states:

(1) General rule—In the case of a taxpayer other than a corporation—

* * *

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

26 U.S.C. §166(d). A taxpayer seeking to take a deduction for a nonbusiness bad debt under §166(d) must establish two elements. First, the taxpayer must establish the existence of a bona fide debt. Treas. Reg. §1.166-1. Second, the taxpayer must establish that this bona fide debt became completely worthless during the taxable year in question. 26 U.S.C. §166(d). In this case, the government contends that plaintiffs cannot establish either element.[1]

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[1] The government argues that the supposedly inconsistent positions taken by plaintiffs in their administrative refund action and in their complaint is fatal to their cause here. The government maintains that plaintiffs argued in their administrative refund proceeding that Gordon was Spaulding's creditor, while claiming in their complaint that Gordon was Spaulding's guarantor. In making this argument, the government seizes upon the use of the word "guaranty" in plaintiffs' complaint. However, it is perfectly clear from the rest of the complaint that plaintiffs have endeavored to prove that Gordon was Spaulding's creditor. Indeed, we did not consider it necessary for plaintiffs to amend that portion of their complaint to remove any ambiguity. In addition, inasmuch as the government concedes that at all relevant times Gordon was primarily liable to First Chicago, we find that Gordon clearly was not a guarantor and all issues regarding guarantor-taxpayers are irrelevant to this case.

B. *The Existence of a Bona Fide Debt*

The Treasury Regulations require that in order to establish the existence of a bona fide debt the taxpayer must demonstrate "a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed and determinable sum of money." Treas. Reg. 1.166-1(c). Specifically excluded from the definition of a bona fide debt are gifts and contributions to capital.[2] *Id.*

Since Gordon does not fall into one of the specific exclusions found in Treas. Reg. 1.166-l(c), we must determine when and if a debtor-creditor relationship existed between Spaulding and Gordon. The starting point for determining whether such a relationship exists is the subjective intent of the parties to the transaction. *See Saunders v. Commissioner*, 720 F.2d 871, 873 (5th Cir. 1983); *Stinnett's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984) (holding that the intent of the parties helps determine whether a particular transaction qualifies as a debt). If the taxpayer can establish that he had a legitimate expectation of repayment, and that the alleged debtor also intended to repay the funds in question, he will ordinarily have established the existence of a bona fide debt. In addition, this subjective intent must also reconcile with the objective char-

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[2] We can quickly dispense of the government's contention that Gordon's actions were either a gift or a contribution to capital. Peacock was Spaulding's sole shareholder and therefore any monies tendered to Spaulding by Gordon cannot be characterized as a contribution to capital. In addition, there is no evidence that Gordon intended to make a gift through restructuring Spaulding's debt. There is no indication of any donative intent, and we will not infer such intent in the absence of any evidence when the alleged gift in question is such a sizable sum.

acteristics of the transaction. That is, the parties could have intended to create a debtor-creditor relationship but in fact failed to do so, or the objective characteristics of the transaction may indicate that the parties did not truly intend to create a debt. *Stinnett's Pontiac Service*, 730 F.2d at 639. These objective characteristics include whether the parties executed loan agreements, whether collateral was given, whether a specific period of repayment was established, whether interest was paid, the financial condition of the debtor, and whether repayment was contingent on other factors. *See Id.* at 638; 8 Mertens, *Law of Federal Income Taxation*, §30.04 at p.31 (1989).

Neither party has addressed whether this inquiry is a question of fact or law. We believe that the inquiry into whether a bona fide debt exists is a question of fact. The critical question is the intent of the parties and the reasonableness of that intent, which are consummate questions of fact. *Accord*, *Saunders*, 720 F.2d at 873; *Magee v. Commissioner*, 66 T.C.M. 105 (1993) (recognizing a "fact and circumstances" approach to this issue); 8 Mertens, *Law of Federal Income Taxation*, §30.04 at p.34 (1989); *but see Texas Farm Bureau v. United States*, 732 F.2d 437, 438 (5th Cir. 1984) (holding that determining whether a particular expense is a debt or a contribution to capital is a question of law in that it does not depend on the parties' intent but on certain objective factors).

We conclude that there is no genuine issue of material fact that a debtor-creditor relationship existed in June, 1986. The plaintiffs indicated they expected repayment from Spaulding. Further, Peacock testified that Spaulding was obligated to repay Gordon $2.1 million, and the government has stipulated that Peacock did intend to

repay the money. The government presents nothing of its own to contradict this evidence of subjective intent. Rather, the government claims that the lack of any formal indicia of indebtedness, such as a loan agreement or collateral, indicates that such a relationship was not created in fact. Plaintiffs, however, have successfully rebutted that argument. The government admits that Spaulding recorded in its corporate records that it owed Gordon money. Moreover, plaintiffs have shown that the $2.1 million advance was intended only to be a short-term arrangement. Peacock's testimony and records from First Chicago indicate that Gordon would become sole obligor of the debt to give Spaulding time to find another bank to pay off the First Chicago debt. The short term nature of the arrangement obviated the need to discuss interest provisions and the period for repayment. Only later, when it became clear that Spaulding would not receive a loan from a different bank, did the parties need to formalize their agreement, which they did in 1987. Finally, it is undisputed that the bankruptcy court concluded that Gordon was Spaulding's creditor, and that the debt was created before 1987.[3] While this finding of the bankruptcy court is not binding on us here, it is a factor that we should consider in deciding whether a debt was created.

The government advances two arguments in an attempt to stave off summary judgment on this issue. First, the government claims that even if a debtor-creditor relationship was intended by the parties, there can

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[3] The bankruptcy court concluded that the security agreements executed in 1987 were on account of an antecedent debt.

be no bona fide debt for §166 purposes unless that debt had value when it was created. *See Arriconi v. Commissioner*, 73 T.C. 792, 798 (1980); *Markle v. Commissioner*, 17 T.C. 1593 (1952); *Pierson v. Commissioner*, 27 T.C. 330 (1956), *aff'd* 253 F.2d 928. This rule was developed because evidence of the *ab initio* worthlessness of a debt demonstrates that the taxpayer could not have had a reasonable expectation of repayment. However, this rule is applicable only if the taxpayer knew that the debt was worthless when he acquired it. This is so because if the taxpayer was not aware that the debt did not have value, the worthlessness of the debt does not help inform whether or not the taxpayer had a reasonable belief that he would be repaid. In this case, plaintiffs have demonstrated that Gordon believed that Spaulding could repay the $2.1 million. Since he was not an officer or shareholder of the corporation, Gordon's knowledge of Spaulding's financial condition was limited to what Peacock related to him. The evidence reveals that Peacock told both Gordon and First Chicago that he expected to get a loan from a different bank and pay off the First Chicago indebtedness, which means from Gordon's perspective, any debt he acquired from Spaulding would certainly have value. The government presents nothing of its own, to contradict this evidence. Therefore, since it is undisputed that Gordon believed that Spaulding could repay the loan, plaintiffs have proved the existence of a bona fide debt despite the potential *ab initio* worthlessness of that debt.[4]

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[4] An alternate basis for our holding here is provided by *Martin v. Commissioner*, 38 T.C. 188 (1962). In *Martin*, the taxpayers were forced to pay off the mechanics liens on their

(continued...)

Second, the government argues that the Supreme Court's decision in *Eckert v. Burnet*, 283 U.S. 140 (1931) requires us to hold that no bona fide debt was created here. In *Eckert*, the Court held that a cash-basis taxpayer who satisfies his guaranty of another's debt by tendering his own personal note for that loan, has not incurred a debt for §166 purposes. The government argues that Gordon, who is a cash-basis taxpayer, merely substituted his personal note in satisfaction of Spaulding's loan and therefore has not incurred a bona fide debt. We disagree because here, Gordon was always primarily liable on Spaulding's debt. The government has failed to cite a single case applying *Eckert* to a situation such as this and we decline the opportunity to be the first court to so hold.

Since we conclude that plaintiffs have established the existence of a bona fide debt of $2.1 million, we must determine his basis in that debt. This is so because the Treasury Regulations limit a bad debt loss to "the adjusted basis prescribed by §1.1011-1 for determining the loss from the sale or disposition of other property." Treas.

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[4] (...continued)
house after their builder failed to meet his obligations. The Tax Court concluded that the taxpayers were subrogated to the rights of holder of the mechanics lien and became the involuntary creditor of their builder, and were entitled to a nonbusiness bad debt deduction after they established that the debt was worthless. The court in *Martin* seemed to adopt the more sweeping rule that as long as the taxpayer paid off the debt of another for sound business reasons, the taxpayer should be treated as an involuntary creditor and need not ever prove that the debt had value. We need not rely on the expansive holding of *Martin* to find for plaintiffs on this issue because it is undisputed that Gordon was not aware that the debt might not have value when he acquired it.

Reg. §1.166-l(d)(1). Treasury Regulation 1.1011-1 states that "[t]he adjusted basis for determining the gain or loss from the sale or disposition of property is the cost or other basis prescribed in §1012 or other applicable provisions of Subtitle A of the Code." Elsewhere the Regulations state that cost equals the sum of cash paid or liabilities incurred. In this case, in June of 1986 Gordon gave Spaulding $300,000 of his own money. Further, at that time Gordon incurred an additional sole $1.8 million liability to satisfy Spaulding's debt. Therefore, the sum of cash paid and liabilities incurred in 1986 totaled $2.1 million, which qualifies as plaintiffs' basis in the debt in 1986.

C. *If and When the Debt Became Completely Worthless*

The second element a taxpayer must establish for a §166 deduction is that the debt became totally worthless during the taxable year. It is clear from the statute that partial worthlessness does not suffice—rather, the "last vestige of value" must disappear for the debt to be deductible. *See Bodzy v. Commissioner*, 321 F.2d 331 (5th Cir. 1963).

Generally, a claim of worthlessness requires an examination of all "pertinent evidence" impacting on the value of the debt. *See* Treas. Reg. §1.122-2(a). The Seventh Circuit in *Cole v. Commissioner*, 871 F.2d 64, 67 (7th Cir. 1989), analyzed the factors that should be considered when determining whether or not a debt became worth-

less in any particular taxable year.[5] Generally "[p]roof of worthlessness requires . . . a showing of identifiable events demonstrating the valuelessness of the debt and justifying abandonment of hope of recovery." *Id.* Factors indicating worthlessness include

> "the debtor's serious financial reverses, insolvency, lack of assets, persistent refusals to pay on demand, ill health, death, disappearance, abandonment of business, bankruptcy, and receivership, as well as the debt's unsecured or subordinated status and expiration of the statute of limitations."

Id. (quoting 2 Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶ 33.3, at 33-11 (1981)). On the other hand, factors indicating that a debt is not worthless include

> "the creditor's failure to press for payment (especially if the debtor is a relative of friend), willingness to make further advances, availability of collateral or guarantees by third parties, the debtor's earning capacity, minor defaults, payment of interest, and sluggish business conditions."

Id. (quoting 2 Bittker at 33-11). The time frame of this inquiry is important; that is, a claim of worthlessness is examined with the facts as they existed at the end of the tax year. 8 Mertens, *Law of Federal Income Taxation*, §30.75 at p.196 (1989). Finally, the Seventh Circuit has held that " '[w]orthlessness' is a question of fact." *Cole*, 871 F.2d at 66.

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[5] While Cole involved a deduction for a business bad debt under §166(a), we think the concept of worthlessness is the same for the nonbusiness bad debts deduction as for the business bad debts deduction and will therefore use the factors outlined in that opinion.

What do we know about the value of the debt in 1986 and 1987? We know that First Chicago thought it had value into 1986 and that Gordon thought it had value later than that. Indeed, the return amendments claiming the deduction were not filed until about the end of 1988. We must look to the circumstances as they existed in 1986 and 1987, even though those circumstances may not have been fully disclosed until later, and we should not consider the impact of any subsequent events that could not reasonably have been anticipated in 1986 and 1987. Finally, we must recognize that while the time when a debt becomes worthless may be precisely identified by an event such as a fire or an explosion, it is usually not something that can be determined with certainty. The determination of that time when hope must give way to a conclusion that there is no reasonable expectation of recovery is, ultimately, the exercise of a sound business judgment dependent upon numerous factors.

There is no question of fact but that Spaulding's debt to plaintiffs was worthless in 1986 or 1987. Spaulding's tax returns for 1986 and 1987 demonstrate that the company's liabilities far exceeded its assets and that the company was operating at a net loss. Tax returns from previous years demonstrate that Spaulding's steadily worsening financial condition cannot be labeled as merely a period of sluggish business conditions. Rather, it is clear that it was extremely unlikely that Spaulding would ever be able to cover its ballooning debt. This conclusion is supported by many other factors. First, the bankruptcy court concluded that Spaulding was insolvent (for bankruptcy purposes) as early as 1986. Second, First Chicago, which had previously always been willing to

grant Spaulding credit and upon which Spaulding depended, refused to do so for the first time in 1986 and demanded repayment of the existing debt. Third, after First Chicago refused to extend Spaulding credit, Spaulding was unable to procure financing from any other lending institution. Fourth, plaintiffs' expert testified that under generally accepted auditing standards, Spaulding was absolutely not a going concern in 1986 and had no chance of discharging its short-term debt. The government did not submit an expert's affidavit to contradict these conclusions. Fifth, plaintiffs' grandson, who was an officer of Spaulding, testified that Spaulding was having difficulties meeting its payroll obligations and had begun issuing IOU's to creditors. Sixth, it is undisputed that Spaulding was substantially behind on its payroll taxes and rent payments. Finally, a liquidation analysis at July 31, 1986, supports the view that liquidation at that point would have wiped out Spaulding's unsecured creditors, and that is Gordon's status by determination of the bankruptcy court.

The government responds with three arguments of its own. First, the government maintains that the debt cannot be deemed worthless because Spaulding was meeting all interest obligations on the debt until August, 1988. We agree with the government that generally a debtor's payments on the debt militate strongly against a finding of worthlessness. This case is different, however, because Spaulding was meeting its interest obligations only because of the infusion of funds from Molly's estate and because it was wrongly withholding payroll taxes. Whether the funds from Molly's estate is considered a loan, which would have increased Spaulding's indebtedness, or misappropriated, which would have resulted in taxable

income which also would have increased Spaulding's and Peacock's liabilities, it is clear that Spaulding was meeting its interest obligations only by going further in debt. Thus, the fact that Molly's estate provided a temporary infusion of cash does change the fact that Spaulding's financial condition was terminal as early as 1986.

Second, the government alleges that the security interest granted by Spaulding, and Peacock's personal guaranty, added worth to the debt. We disagree. Plaintiffs have demonstrated that in light of Spaulding's massive indebtedness (including back taxes) there was no reasonable possibility in 1987 of payment from Spaulding's or Peacock's bankruptcy estates. As we have noted, the liquidation value of Spaulding's inventory, less liquidation expenses, plus the accounts receivable could not have expected to yield any material payment to plaintiffs. Any funds available in the bankruptcy would first be applied to pay off any unpaid taxes and penalties. *See* 11 U.S.C. §507(a)(7) (priority for unpaid taxes). It was extremely unlikely that Spaulding would have any funds available after paying off these priority claims. Thus, Gordon's security was itself without value.

The government's final argument is that the debt cannot be deemed worthless because plaintiffs received distributions from Spaulding's and Peacock's bankruptcy estates. The government must be able to demonstrate that these recoveries were reasonably foreseeable at the end of the tax years in question. *Estate of Mann*, 731 F.2d at 277. A recovery on a debt does not necessarily defeat a taxpayer's claim that that debt was worthless in a prior year. In the event that a taxpayer unexpectedly recovers part of a debt that was deducted as worthless in a prior tax year, the taxpayer must report these funds as

income in the years in which the unexpected recoveries occurred. *See* 26 U.S.C. §111. However, the government has failed to create a genuine issue of fact on this issue. As was explained above, the expectation in 1986 and 1987 is that Spaulding and Peacock would never be able to repay any material portion of the debt owed to plaintiffs.

We must keep in mind that Spaulding had had the benefit of a substantial cash infusion, approximately $648,000. Peacock, as a co-trustee, withdrew that amount from Molly's estate and transferred it to Spaulding. It appears that he had no right to do so and that the government could have treated it as income both to him and to Spaulding, with a significant diminution of the assets of both for the priority payment of additional taxes. The government did not however challenge those payments. Indeed, it has not challenged the estate's claim that the debt was worthless in May 1987. There was, accordingly, an unexpected receipt by Spaulding of far more than Gordon's ultimate recovery and a potential significant tax liability of Peacock's that was never realized. When we consider, as we should, the $90,000 Gordon has expended in his efforts to collect what he has realized and expects to realize from the bankruptcy estates, the net recovery to him appears to be largely or entirely the result of the government's decisions to pursue him and not others. A fortuitous partial recovery in a later year does not however change the fact that no one could reasonably believe that the debt had any value in 1986 or 1987.

Although this is a close case, there is no disputed facts which would indicate that the debt had any value in either of the taxable years in question. Spaulding was so

hopelessly insolvent in those years that the possibility of repayment was too remote to postpone a finding of worthlessness. Given all the facts as they were known in 1986 and 1987, no reasonable commercial entity would have paid anything more than a de minimis amount for the Spaulding indebtedness. If the debt has no value in the marketplace, then it is worthless for tax purposes. Therefore, we hold that the $2.1 million debt was worthless for §166 purposes in either 1986 or 1987.

CONCLUSION

For the foregoing reasons defendant's motion for summary judgment is denied, and plaintiffs' cross-motion for summary judgment is granted.

/s/ James B. Moran
JAMES B. MORAN,
Chief Judge, U.S. District Court

June 27, 1995.

[Dated May 6, 1996]

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT ILLINOIS
EASTERN DIVISION

MARY BUCHANAN and GORDON BUCHANAN, JR.,	)	
	)	CIVIL ACTION
Plaintiffs,	)	91-C-3831
v.	)	
	)	SENIOR JUDGE
UNITED STATES OF AMERICA,	)	JAMES MORAN
Defendant.	)	

ORDER PROVIDING FOR ENTRY OF FINAL JUDGMENT

On June 27, 1995, this Court entered its "Memorandum and Order" determining to grant the Plaintiffs' motion for summary judgment and to deny the United States' cross-motion for summary judgment, upon which the Clerk entered a Judgment to the same effect on June 28, 1995. Plaintiffs then moved for sanctions, which this Court denied. The United States appealed the judgment, as well as this Court's denial of the United States' Rule 59(e) motion, and Plaintiffs appealed the denial of their motion for sanctions, after which the appeals were consolidated (as Seventh Circuit Docket Nos. 95-3057 and 95-3145). On April 9, 1996, the appeals were dismissed because the Court of Appeals determined that there was no final judgment. The panel's opinion (p. 3) states that, "[i]f the parties are able to agree on what amount is due the plaintiffs if they prevail on appeal, the district judge will no doubt enter judgment in that amount and the government can file a new appeal, which will be assigned

to this panel without need for submission of new briefs, or further argument, on the merits." The parties have agreed to the amount of the judgment and the form of this order. Therefore, it is

ORDERED, ADJUDGED, AND DECREED as follows:

A. The debt of Spaulding to the Plaintiffs became wholly worthless in 1986.

B. That debt continued to be wholly worthless throughout 1987.

C. The Clerk of the Court is directed to enter a judgment in favor of the Plaintiffs as follows: Plaintiffs shall have judgment that they overpaid their federal income tax for the year 1986 in the amount of $106,378.00 plus statutory interest (from April 15, 1987), and overpaid their federal income tax for the year 1987 in the amount of $436,073.00 plus statutory interest (from April 15, 1988).

D. All prior orders, including but not limited to the orders of August 8, 1995 and September 14, 1995, concerning the denial of Plaintiffs' motion for sanctions, are rendered final and appealable by the entry of this order.

E. Although this order has been agreed to by the parties, such agreement preserves their rights to further pursue appeals of this order and the judgment entered pursuant hereto, as well as all prior orders that are rendered final and appealable by the entry of this order.

DATED THIS 6th DAY OF May, 1996, AT CHICAGO, ILLINOIS.

/s/ James B. Moran
JAMES B. MORAN
UNITED STATES DISTRICT COURT JUDGE

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JUDGMENT IN A CIVIL CASE

MARY BUCHANAN ET AL.

v. Case Number: 91 C 3831

UNITED STATES OF AMERICA

☐ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED the Clerk of the court is directed to enter a judgment in favor of plaintiffs as follows: plaintiffs shall have judgment that they overpaid their federal income tax for the year of 1986 in the amount of $106,378.00 plus statutory interest (from April 15, 1987), and overpaid their federal income tax for the year 1987 in the amount of $436,073.00 plus statutory interest (from April 15, 1988).

Date May 6, 1996

H. STUART CUNNINGHAM
Clerk

/s/ Willie A. Haynes
(By) Deputy Clerk